

# OPERATIONAL FRAMEWORK FOR INFLATION TARGETING IN SOUTH AFRICA:

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South African Reserve Bank

## Introduction

- Monetary policy obligations are laid out in Reserve Bank Act (1989)
- The inflation target is set by National Treasury in consultation with the Reserve Bank.
- Price index chosen is the headline CPI excluding mortgage interest cost (CPIX).
- Governor reports quarterly to Parliament to discuss recent economic activity and the state of monetary policy .
- No specific sanction or obligation if target is missed.



## SARB Mission

To achieve and maintain price stability

## Constitution Section 224

The primary objective is “to protect the value of the currency of the Republic in the interest of balanced and sustainable economic growth.”



# Autonomy

## Constitution section 224(2)

The SARB, in pursuit of its primary objective, must perform its functions independently and without fear, favor or prejudice



## Inflation Targeting in South Africa

- Official target range of 3 to 6 percent of CPIX
- Formalised since February 2000 – it has remained within the target range since September 2003
- SARB has been remarkably successful in bringing inflation under control during the past four years.
- During this period the operational framework for inflation targeting has continued to evolve.





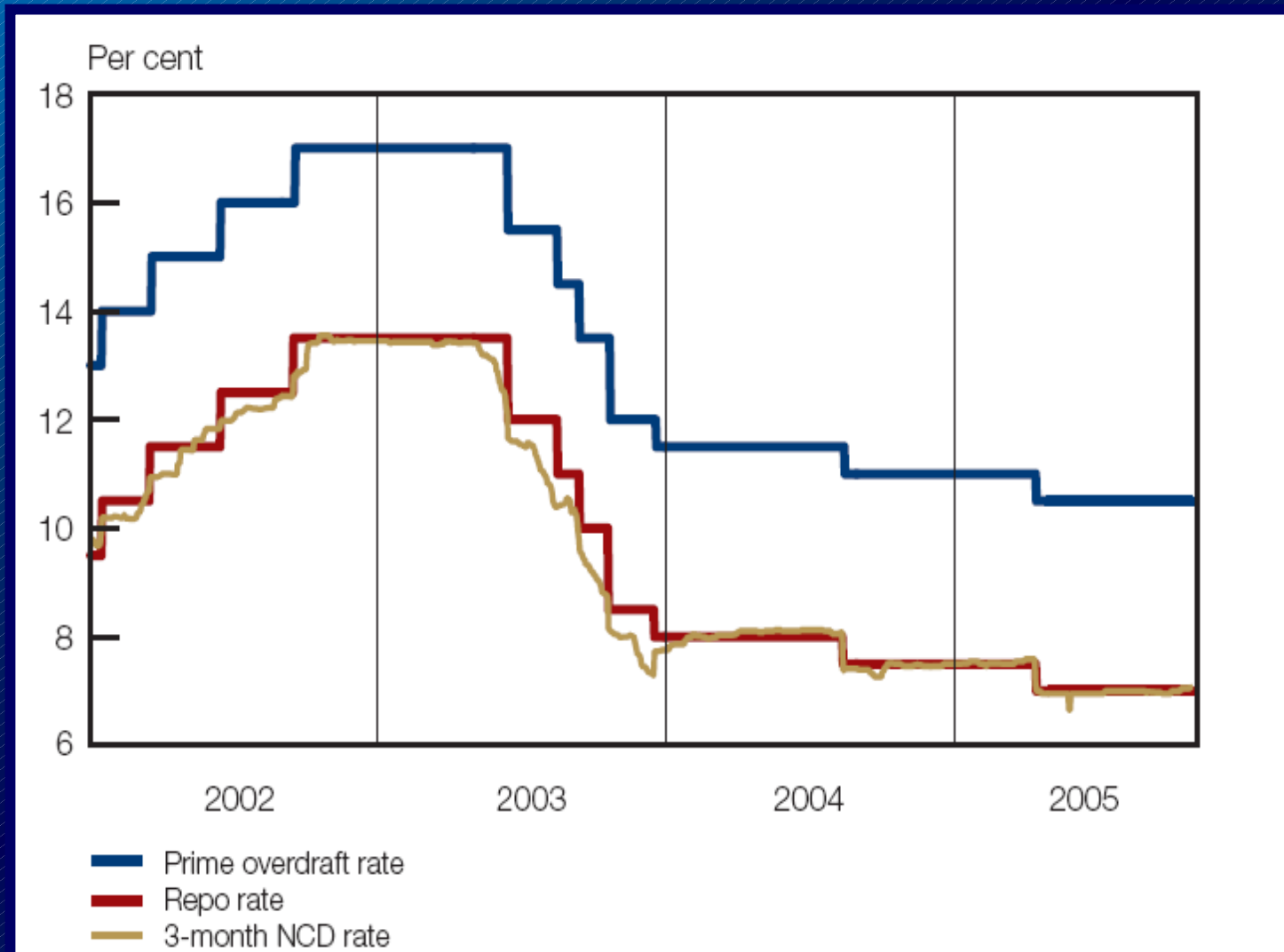
# Inflation targeting range

Inflation target range of 3-6 per cent:

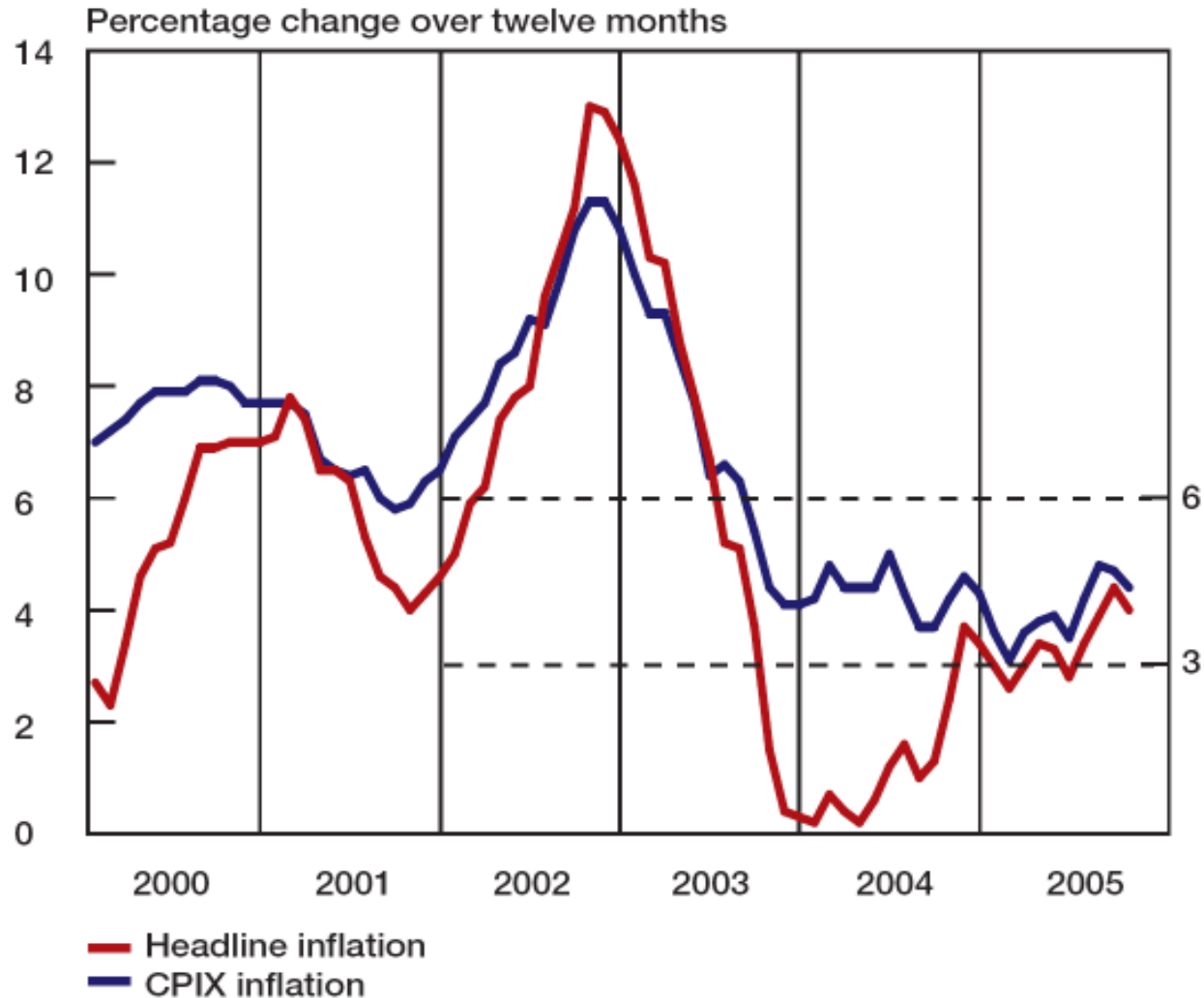
- From a calendar year average to a continuous one
- When IT was introduced CPIX inflation was on an upward path, 7 – 8 per cent (2000)
- Late 2001: currency depreciated by about 37 per cent.. CPIX inflation peaked at 11,3%; Repo rate raised by 400 basis points in four steps
- Currency recovered during 2002-3, helped reverse the upward inflation trend.



# The repo and short-term interest rates



# Headline inflation and CPIX





## Pass-through: exchange rate to inflation

- Initially pass-through in SA had been unexpectedly low. When the depreciation accelerated, inflation picked up quickly.
- First stage:  $\Delta er \rightarrow \Delta pm$ 
  - rapid and complete

## Pass-through: exchange rate to inflation

- First stage:  $\Delta er \rightarrow \Delta pm$ 
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- Second stage:  $\Delta pm \rightarrow \Delta cpi$ 
  - slower

## Pass-through: exchange rate to inflation

- First stage:  $\Delta er \rightarrow \Delta pm$ 
  - rapid and complete
- Second stage:  $\Delta pm \rightarrow \Delta cpi$ 
  - slower
  - has declined

## BER survey of CPIX inflation expectations: 3rd quarter 2005\*

Per cent

	2005	2006	2007
1. Finance	(4,2) 4,3	(5,0) 5,3	(4,9) 5,1
2. Business	(4,7) 4,8	(5,0) 5,2	(5,4) 5,5
3. Labour	(4,6) 5,1	(4,7) 5,2	(4,7) 5,5
Average 1 – 3	(4,5) 4,7	(4,9) 5,2	(5,0) 5,4

\* Second-quarter 2005 results in parentheses

Source: Bureau for Economic Research, University of Stellenbosch



# Exchange Rates

- Important to have appropriate exchange rate levels.
- Misaligned exchange rates result in resource misallocation
- Not easy to determine correct levels, exchange rates do overshoot.
- Also need to distinguish between equilibrium movements and movements from equilibrium.
- In an IT environment, need exchange rate flexibility.
- Fixed exchange rates are compatible with low inflation, but prone to crises.
- Need to be able to respond to shocks, including commodity price increases/decreases

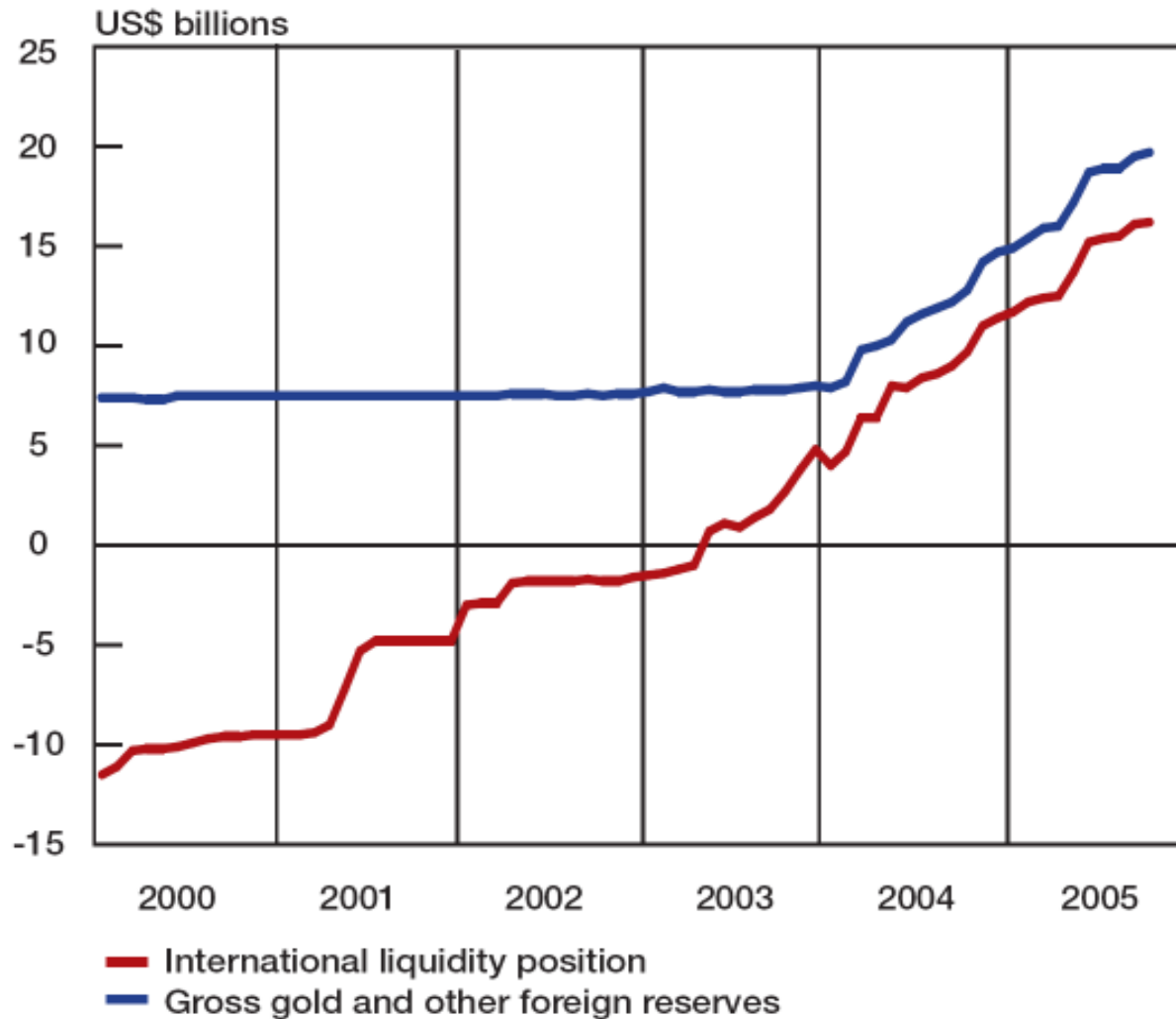


## Exchange rates (cont)

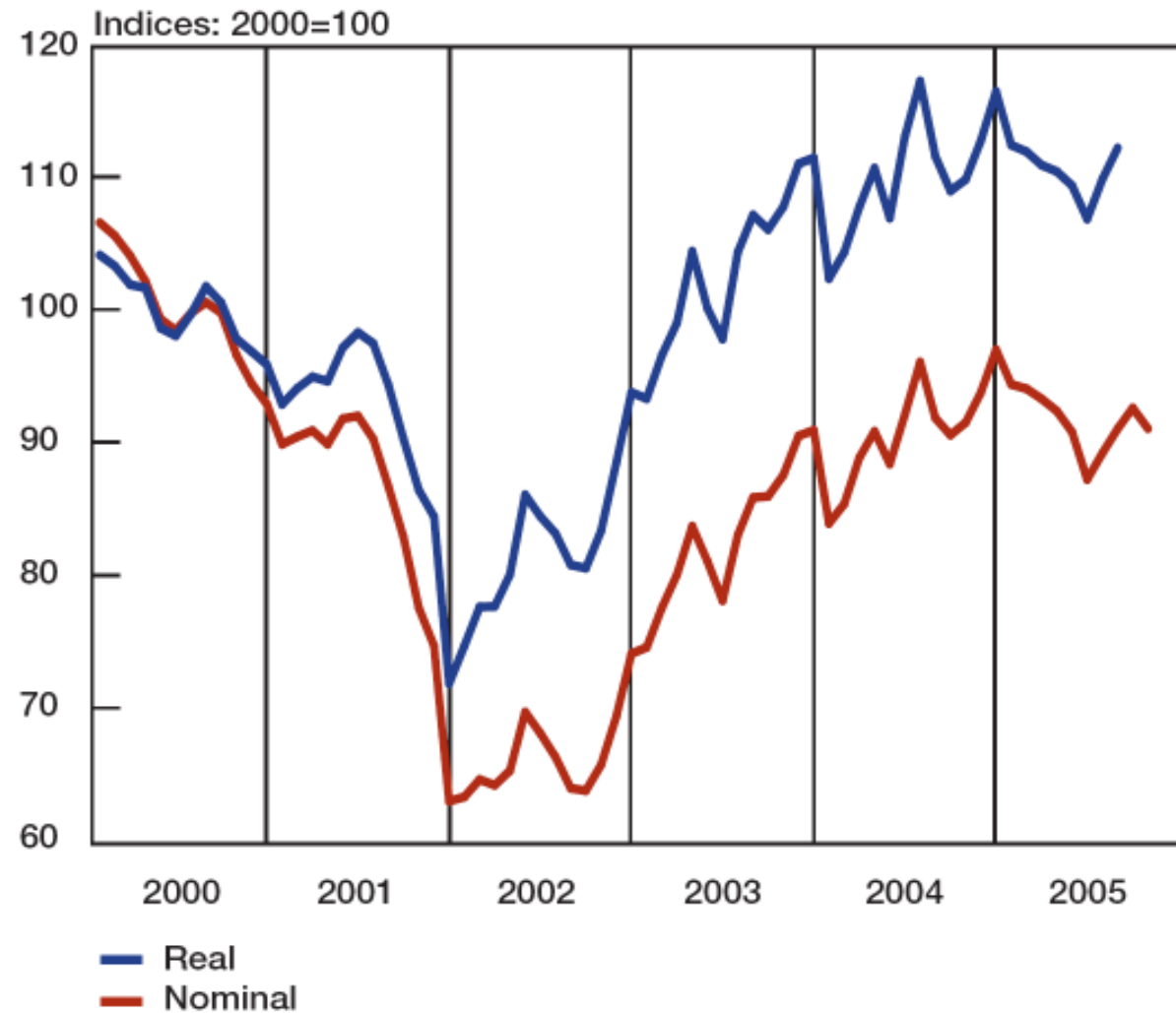
- Till recently rand viewed as a one way bet- persistent depreciation leading to persistent inflation.
- Structural factors have changed - NOFP expunged, reserves now positive, higher credit ratings.
- Challenge is to provide the environment for increased exchange rate stability.



# Gross gold and other foreign reserves and international liquidity position of the South African Reserve Bank



# Effective exchange rates of the rand



## SARB recent history on intervention

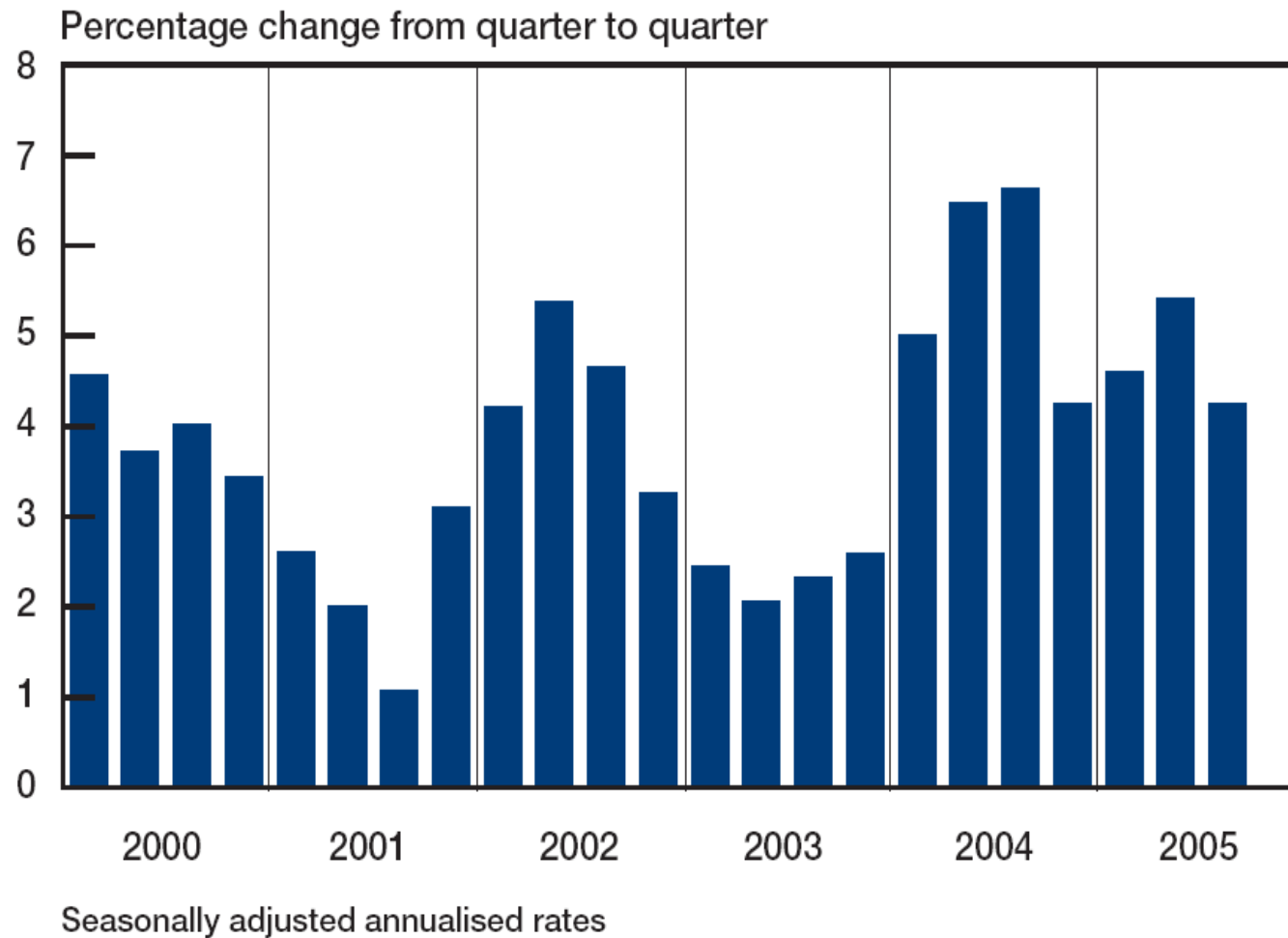
- The adoption of an inflation targeting framework in 2000 together with a freely floating exchange rate has led to substantial swings in the exchange rate of the rand.
- SARB does not target the exchange rate level
- The Bank can intervene in the forex market to smooth fluctuations in the market
- SARB's intervention policy experience had been costly than experienced in other CBs....



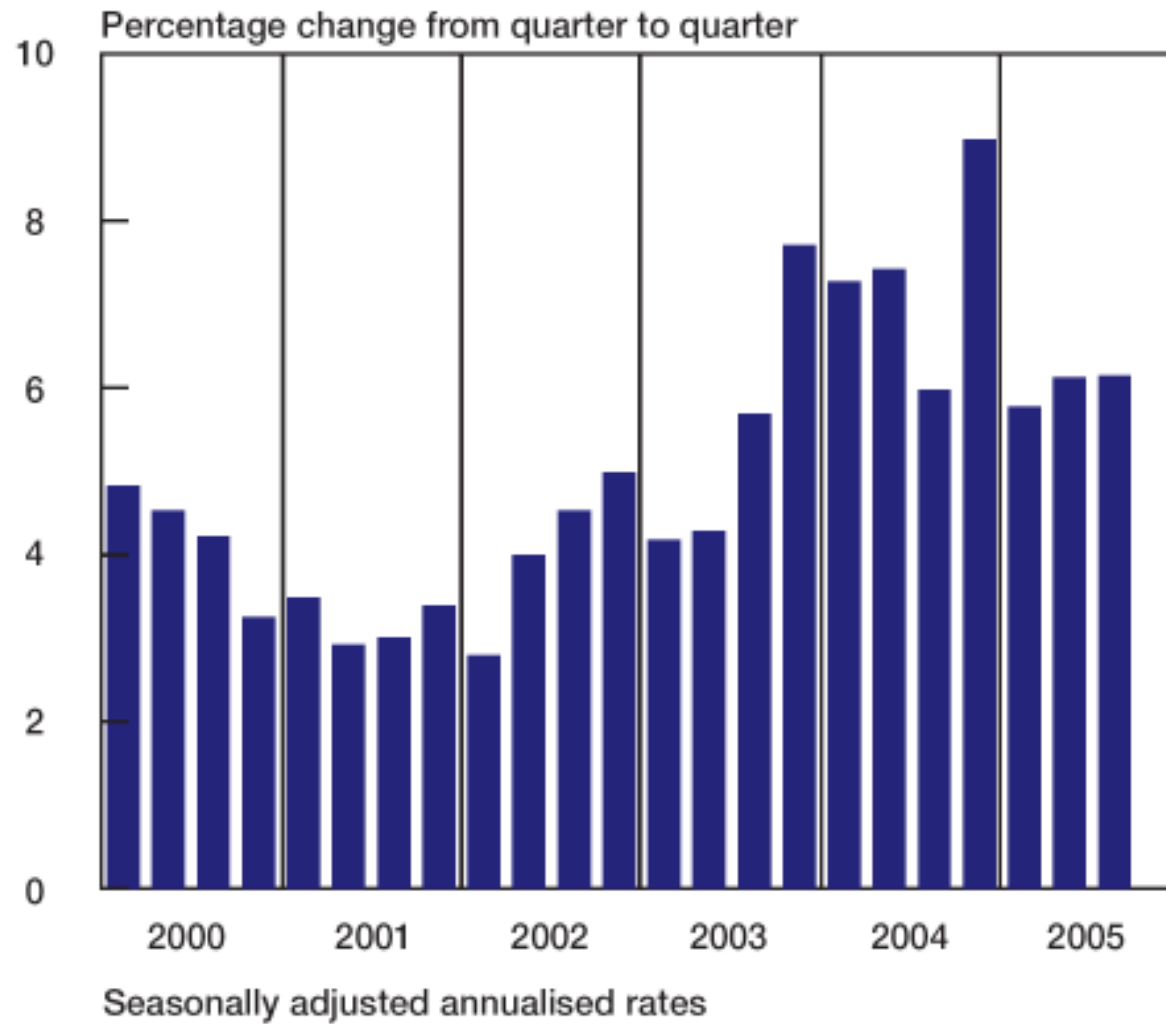
## Growth and IT

- Can we stimulate growth by weakening the exchange rate? No easy way to do this, unless we go for excessively low interest rates, which may have a short run positive impact on growth, but will be self-defeating in the longer run.

# Real gross domestic product



# Real domestic final demand





# The Monetary Policy Committee

- Responsibility for monetary policy decision-making is entrusted to the Monetary Policy Committee.
- Decisions made by Monetary Policy Committee, meeting over two days every two months.
- Decision-making by consensus.

# Monetary Policy Transparency

- The MPC meets at predetermined intervals and on dates published at least a year in advance.
- Minutes not released but detailed statement accompanies the announcement of the MPC decision.
- Monetary Policy Forums held twice a year in 9 centres around the country.



# Monetary Policy Transparency

- SARB issues an inflation report (Monetary Policy Review) twice a year.
- The Review analyses developments in and factors influencing inflation, assesses recent domestic and international policy developments and considers the outlook for inflation.
- The Review reports on the MPC's assessment of inflation and the inflation forecast, hence providing an ex post insight into matters deliberated by the MPC.

# Monetary Policy Forums

- The first meeting of a Monetary Policy Forum was held in Pretoria on 20 March 2000.
- Currently the Bank hosts Forums biannually in 10 major cities.
- The regional Forums provide for discussions on monetary policy over a broad geographical spectrum involving many stakeholders including trade union representatives, analysts, academics and the media.

## Other steps to improve transparency

- The Governor's briefing sessions with media representatives.
- Speeches by the Governor, deputy governors and other senior officials of the Bank.
- The annual Governor's Address provides a comprehensive monetary policy overview.
- The Bank's website ([www.reservebank.co.za](http://www.reservebank.co.za)) is used extensively to keep the media and all staff members of the Bank abreast of important developments.





## Other steps to improve transparency (continued)

- An annual SARB general management conference to ensure that all SARB managers (and in turn their subordinates) are briefed about new developments as well as the Bank's efforts in containing inflation and achieving the inflation target.
- Periodic briefings by deputy governors to general management on issues pertaining to the activities of the Bank and factors influencing monetary policy decisions.

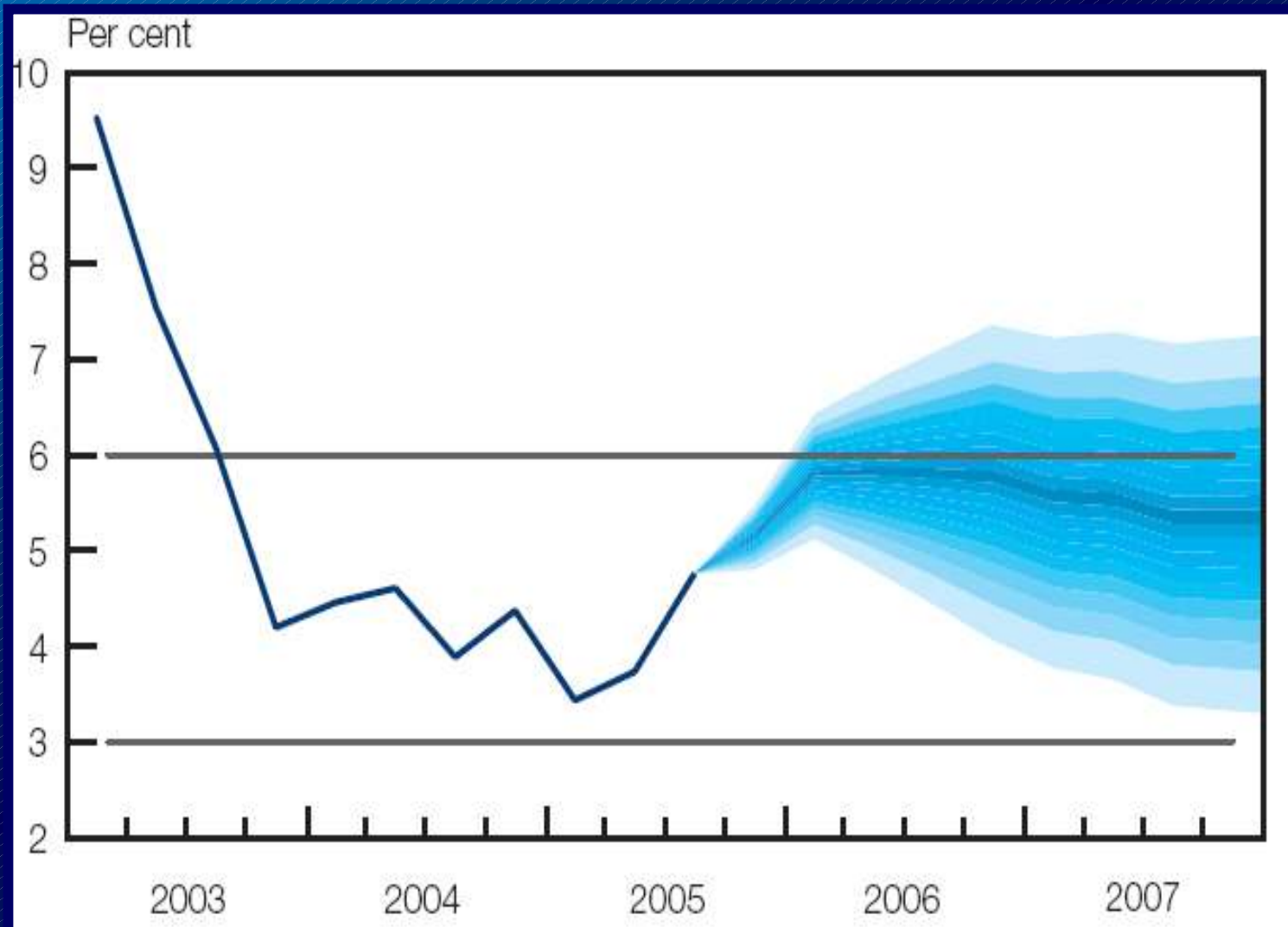


# Annual Report and Financial Statements

- Reporting and disclosure has increased significantly since the implementation of inflation targeting.
- The Bank now reports on matters much wider than only its financial affairs.
- Owing to its approval by shareholders and the tabling in Parliament, the Annual Report and Financial Statements attracts considerable media attention and has improved accurate reporting on the Bank.



# CPIX forecast



## Concerns about inflation targeting

- Sometimes argued that it ignores real output
- Primacy of inflation target does not imply that there is no concern for real output (strict or flexible targeting).
- Strict inflation targets could lead to output instability- choice of time horizon will be determined by the weight given to output variability in Bank's objective function.
- The further inflation is from the target, the more strict the monetary authorities are likely to be.

## Conclusion

- Inflation targeting has resulted in greater monetary policy transparency in South Africa
- Monetary policy decisions have become focused on the longer-term target and have brought less variability of interest rates
- Inflation targeting has played a role in strengthening the effect of forward-looking expectations on inflation.

*Thank you!*